



# Why Governments Failed to Realize Prosperity and How to Structure a Sound Economic System

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## ABSTRACT

One of the main functions of a government is to sustain all its population at or above the prosperity level which expresses the feasible material standard of living that an economy can provide. Governments failed to realize prosperity. Financial distress is increasing. More than 3 billion people live on less than \$2.50 a day. Living standard of middle class declines. Scarcity of resources, lack of funds, growth in public services, and absence of an International monetary system are presented by politicians and economists as the main factors that cause the failure of the present economic systems to realize prosperity. This paper aims to discuss each of these factors, highlight the pitfalls in economic thinking, and look for an alternative economic system that would reflect fair economy and advance the needs of humanity as a whole.

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## **1. Introduction**

Economics studies the many activities undertaken in relation to wealth. Economic activities take place in the framework of an economic system. Each of the present economic systems advocates different features that represent the ways by which a society utilizes available resources so as to produce, exchange, and distribute wealth.

Material prosperity is the main objective of any sound economic system. Present economic systems failed to realize prosperity. Financial distress is increasing. Corruptions are going on around the world. Public debt is growing. Financial crisis continue to occur from time to time. Confidence in currencies deteriorates. Poverty rate rises. Many wars were created for economical reasons. Economic Instability, growing inflation, and concentration of wealth become the main features of present economies.

Scarcity of resources, lack of funds, growth in public services, and absence of an international monetary system are presented by politicians and economists as excuses to justify the failure of the present economic systems to realize prosperity.

## **2. Scarcity of Resources**

In order to realize prosperity a society has to reach an optimal level of output growth that satisfies the economic requirements of the community and maintains full employment. Economists believe that scarcity of resources restricts output growth because wants are innumerable but the resources for satisfying those wants are limited.

The excess of the world output growth over the growth of the world population emphasizes the abundance of natural resources on the global level. According to the World Bank, the World Development Indicators updated Jul 28, 2011 shows the world output growth in comparison to the world population growth for the years 2010, 2011, 2012, 2013, 2014, and 2015. While the growth rates of the world population were 1.18%, 1.17%, 1.16%, 1.14%, 1.12%, 1.09% respectively, the growth rates of world gross world product GWP were 5.4%, 4.2%, 3.4%, 3.4%, 3.4%, 3.5% respectively.

On the national level, the collection of the available resources may differ from the resources needed for satisfying the requirements of the community. International trade allows the exchange of resources and products. Job vacancies and skills gaps can be filled through immigration. A country with no or very limited resources cannot retain its independency.

It is obvious that scarcity of resources is not a factual problem. Instead; management of resources represents a real problem;

- A society may fail to produce even what would be possible with its existing resources. Natural resources may be underutilized because of the lack of technology to discover or extract resources. Resources maybe inefficiently employed because of the lack of skilled labors or technical knowledge. The stock of natural resources maybe depleted because of the overutilization of resources.
- A society may succeed to attain even higher level of growth required for realization of prosperity, but the collection of national output may differ from the collection that satisfies the requirements of the society. More resources maybe devoted to produce goods of higher profits such as weapons, producers' goods such as machineries, or luxury goods such as pyramids and fancy squares.

It is the responsibility of the decision makers to set proper product mix, raise efficiency through education and training, utilize resources moderately, and encourage local production in order to reduce unemployment rate and reach higher level of output growth. Mismanagement of resources is the direct result of the lack of qualified decision makers who care about public interest. In most cases, appointment or election of a decision maker is based upon his loyalty to the person who appointed him, the political party that supports him, or the financier of his election campaign. An economy may be controlled by those who have special interests such as IMF, creditors, capitalists, financial institutions, and industries or social lobby.

### 3. Lack of Funds

The main objective of a sound monetary system is to raise funds that are sufficient to finance the target output growth. Politicians and economists claim that the lack of funds restricts economic growth.

Unlike the old commodity money that was made of gold or silver or of paper fully backed by gold, present money consists of state-issued money made of paper or metal of negligible cost in addition to banking deposits. Most of money in circulation is banking deposits. Issued money in USA as at January, 2005 was \$700.1 billion, while commercial bank money (in M1) was \$1,353.3 billion.

Governments print fiat money. Fiat money refers to the currency that a government has declared to be legal tender recognized by law to be valid for meeting financial obligations and to be exchanged for goods and services. Unlike the commodity money, fiat money is backed by the national output. Practically, national output is the real currency backing. However, some countries hoard amounts of gold, precious metals, or foreign currencies as currency backing. Kelvin Lancaster of Colombia University says “From one point of view, currency backing is inherently ridiculous and based on public lack of comprehension about the nature of money, but it has one aspect that was of great historical importance: If the currency must be backed, wholly or partially, by something that is inherently scarce, there is a built-in-guarantee that the currency itself will remain scarce.”.

In present economies, interest or profit based lending is the most popular method of raising funds to both public and private sectors;

- In addition to the state-issued money, governments raise funds through selling government bills, or borrowing money from rich countries or giant lenders. Public debt is growing. More taxes are levied to pay interests on public debt.
- Banking deposits are borrowed money. Banks use public and private deposits to grant credits. In order to generate more profits and expand more credits, banks practice what is so called “Money Creation Process” which entitled the banking system to raise funds through lending. Business entities, speculators, and individuals borrow money from banks and financial institutions.

- Public and private corporations including banks borrow money through financial markets. Financial markets encourage speculative activities and introduce financing instruments such as treasury bills and corporate bonds, as well as refinancing products such as mortgage securities.

The output growth within a certain period of time is known as the "National output". It is the total value of all goods and services produced by the society within a certain period of time. Money is needed to pay producers for the national output. Money received by producers in exchange for the real value of national output represents producers' income. Since no more money is needed, the national income should equal producers' income and the quantity of money in circulation should equal the quantity of money needed to reach the target output growth.

In present economies, the national income includes inflationary income in addition to the producers' income. The inflationary income is the returns to the inflationary financial activities which do not add value to the national output. Inflationary financial activities include interest-based lending, speculative activities, financial corruption, and taxation. Because money is used to pay for the inflationary income, the quantity of money in circulation exceeds the quantity of money needed to realize the output growth.

The following simple equation of the classical theory of money shows the relationship between the national output and the national income and determines the quantity of money needed to be injected into the system in order to reach the target national output.

$$\text{National income} = \text{National output} = \text{Quantity of money} * \text{Velocity of money}$$

Where; the velocity of money refers to the number of times a currency unit is used to purchase goods and services within a given time period.

Assume that the velocity of money = 4 times. In order to reach the target national output of 12 billion currency units, 3 billion currency units should be injected into the system. In this case, the national income equals the producers' income which equals 12 billion currency units, and the purchasing power of money which refers to the amount of goods and/or services that each currency unit can buy equals  $12 / 3 = 4$  worth of goods.

Suppose that 4 billion currency units has been injected into the system, the national income will be 16 billion currency units representing producers' income of 12 billion currency units in addition to inflationary income of 4 billion currency units, the purchasing power of the currency unit will decline to be  $= 12 / 4 = 3$  worth of goods, and the market value of the output will increase to be  $= 4 \times 4 = 16$  billion currency units.

Injecting more money into the system without adding real value to the national output causes inflation. The excessive expansion of money which is used to pay for the inflationary income reduces the purchasing power of the currency unit. The reduction in the purchasing power means that each currency unit buys fewer goods and services. The general level of prices rises.

Cost of goods are, directly or indirectly, increased by the interest as financial cost, the increase in prices of goods due to speculations, and the payments of bribes or corruption expenses, in addition to all taxes paid by sellers including taxes on local products, income tax, payroll taxes, and the hidden tax which result from printing money in order to support financial institutions, pay off interest on public debts, or cover financial corruption. The higher cost of goods is the higher sellers' profits. Over and above, consumers pay the after-sale taxes such as sales and consumption taxes.

Inflation is a human-made phenomenon. It differs from the natural increase of prices. The natural increase in prices of some products due to an increase in cost of material, wages paid to labors, supplier's profit margin, or volume of demand relatively to the volume of supply is not inflation. It reflects an increase in the real value of products. Money is used to measure values. Inflation is the root of all evil;

- Inflation represents the main cause of concentration of wealth. Poor becomes poorer. Living standard of middle class declines. Those living on fixed incomes suffer a severe decline in their living standard. Living standard of rich rises. Rich generate profits from appreciation of their assets, and business owners stand to gain from increased profits.
- Inflation is behind social and political instability. Alcoholism, families breaking up and increased criminal rate, public demonstrations, and revolutions are results of financial distress.

- Inflation, as price increase, causes economic instability. Prices soar. Workers have less money to consume. Demand falls because each monetary unit buys fewer goods and services. Exports become more expensive to sell. Imports increase because they are relatively cheaper than locally produced products. Middle class savings are discouraged because consumers have to spend more. Pressure for increased wages mounts to keep up with consumer prices. Unemployment rate rises as a result of the decline in the rate of output growth.
- Inflation, as an intentional decline in the purchasing power of the monetary unit, is responsible for the deterioration of the confidence in the currency. Inflation rate may rise at very high levels destroying the confidence in the currency and leading to currency devaluation and even total monetary collapse. Soviet economy had a period of hyperinflation from 1921 to 1924 due to the sudden removal of speculative capital. In 1992, currency speculation forced the central bank of Sweden to raise interest rates for a few days to 500% per annum, and later to devalue the Swedish currency.
- Inflation, as excessive expansion of credit, is responsible for financial crises such as the Wall Street Crash of 1929, the 2008 US Mortgage Crisis, the 1997 Asian Financial Crisis, 1998 Russian Financial Crisis, and the Latin American Debt Crisis.
- Inflation, in addition to all other human interventions, restricts market freedom.
- Due to inflation, the functions of money have been changed. Present money becomes inflationary tool. Because the purchasing power of the currency unit is unstable, money loses its reliability as a measure of value, and money, as a store of value, cannot protect the right of its holder to obtain products of future value equals the value of the products he might acquire when he received or lent the money.

In spite of the ghastly impacts of inflation, most economists recommend living with moderate inflation. Mainly, they claim that:

1. Inflation provides an incentive for investment as long as prices are rising and are expected to continue rising.
2. Inflation is unavoidable since encouragement of the inflationary financial activities, which produce the inflation, is necessary to raise funds.

This way of thinking is based on fallacies:

1. Making profit is the real incentive for investment. Investors can make profit even with no inflation.
2. The main objective of a sound monetary system is to raise as much funds as needed for the output growth. The excess of money supply over the quantity of money needed for the output growth is used to pay for the inflationary income that do not add value to the national output.
3. There are no restrictions on the government to print as much money as needed for the output growth.
4. Raising funds that are justified by the output growth does not require encouragement of the inflationary financial activities.
5. Raising funds through producing inflation is questionable because rich are the only beneficiaries from inflation. A study by the World Institute for Development Economics Research at United Nations University reports that the richest 1% of adults alone owned 40% of global assets in the year 2000, and that the richest 10% of adults accounted for 85% of the world total assets. In contrast, the bottom half of the world adult population owned barely 1% of global wealth.
6. Since inflation restricts output growth, the objective of the monetary system has been changed. The present monetary system aims to control quantity of money in order to prevent the probable detrimental impacts of inflation. Monetary authorities apply monetary controls over interest rate, bank discount rate, expansion of money, and currency exchange.



Governments employ fiscal controls over prices, wages, government expenditure, and taxes. Markets may not respond in the way expected by the authority. High rate of inflation may lead to hyperinflation, stagflation, recession, high unemployment rate, and even total monetary collapse.

Some economists become aware of the inflationary role of money. The Congressman Dennis Kucinich introduced the act HR2990. It is stated that, the purpose of this act is to create a Monetary Authority which shall pursue a monetary policy based on the governing principle that the supply of money in circulation should not become inflationary or deflationary. The recommendations include reconstruction of the Federal Reserve, establishment of the United States Monetary Authority, conversion of Federal Reserve Notes to United States Money, abolishment of the creation of money by private persons through lending against deposits, and replacement of fractional reserve banking with the lending of United States Money.

In order to get rid of inflation, structuring of the national monetary system should be based on transformation of present inflationary economies into productive economies. A sound national monetary system has four main objectives:

1. To provide funds required for the exchange of the goods and services that are produced in the economy.
2. To finance the deficit in the cash flows of productive businesses and projects.
3. To ensure stability of the purchasing power of the currency unit in order to protect the rights of money holders.
4. To combat financial corruption.

If money supply is growing at the same rapid that is justified by the growth of national output, funds can be freely raised, without causing inflation and with no need to borrow money, retain currency reserve, apply spending-cut policies, ask for foreign grants or even seek private investments. The national output is the real currency backing.

Instead of directing the domestic monetary policy toward controlling *quantity of money* in order to limit the growth of inflation, the domestic monetary policy should be directed toward

controlling ***movement of money*** in order to limit the growth of money supply to the growth of national output.

Looseness of present monetary system does not help controlling movement of money. Funds are raised by the monetary authority and all banks. Money is available in form of banknotes, coins and banking deposits. It circulates in hands of individuals, public entities, private entities, and the government. Part of money is hoarded or saved, and another part is invested abroad.

Effective control of movement of money requires transformation into a closed monetary system by which funds is provided by and circulated within a governmental monetary authority or central bank. The closed monetary system is presented as an alternative to both present monetary system and financial system. In practice, it requires changing the functions of the central bank and banks:

#### 1. Functions of Central Bank (CB)

CB does not issue money. Instead, it provides all banking services in local and foreign currencies. Cash money in local currency is recalled for cancellation. Banking deposits in local currency are transferred to CB. Accounts of banks with CB are charged for the amount of transfers. The debit balance will be settled by the proceeds from liquidating the banking credits.

Cash money and banking deposits in local currency are retained by CB in unrestricted interest-free current accounts in the name of the money owners.

Since each account provides a complete record of receipts and payments of the account holder, the records will help combating financial corruption including illegal operations, tax evasion and procrastination in paying debts by a wealthy man.

All payments in local currency are made by transfers between the accounts retained by CB.

Banking deposits in foreign currencies are transferred to be retained in accounts in the name of the money owners with CB. Foreign currencies are exchanged at the spot rate determined by the exchange market. CB controls movements of foreign currencies.

CB issues prepaid smart cards to be used by consumers for paying sundry expenses. CB issues Interest-free credit cards to consumers in order to encourage consumption. CB grants temporary interest-free lines of credits to governmental agencies in order to cover the deficit in the cash flows.

Under its supervision and control, CB finances private and public productive activities through banks.

## 2. Functions of banks

Banks do not retain deposits. Instead, they, as specialized financial institutions, use funds received from CB to finance productive activities.

A bank invests money with one or more partners in a productive project (or business). CB is a partner liable to cover the shortage in the cash flow. A current equity finance contract translates the relationship between the bank and the partners. It shows type and terms of finance, the profit share of every party, including the bank, in return for his efforts or work, the initial capital of the project, the minimum of the capital share of every partner. A partner has the right to change his capital share provided that it will not be less than the predetermined minimum share.

All payments and receipts are made by transfers through accounts with CB.

Liquidation is made by selling the assets in cash to others or to a partner or to CB at market price. If CB is the buyer, it will sell or rent the assets at its own risk.

On liquidation, accounting is made on cash base. In case of profit, the profit share of every party for his efforts or work is paid. Capital is recovered and net profit or loss is distributed in proportion to the accumulated invested capital computed by using the well-known "Daily Numbers Method".

#### **4. Growth in Public Services**

As the community has grown in size, organizations, and complexity, so the services provided by governments have increased, and these services have to be paid for. This raises the issue of redistribution of wealth amongst the members of the community. The necessity of redistribution policy arises from the insufficiency of public revenue to meet public expenditures and the insufficiency of private income to meet cost of living.

Socialists favor distribution process based on an individual's needs. Production is adjusted by the State to meet human needs. Socialism failed to realize its concept of equality amongst members of the society.

On the contrary, capitalism is centered about the private ownership of means of production. Capitalist countries provide poor and those of limited income with some social services. Social security and retirement programs aim to help those of older age. Unemployment compensations are paid to those who do not have job. The inflationary taxation, which widens the gap between rich and poor and increase the cost of social services, is used to redistribute wealth and finance the deficit in government budget. In case taxes do not cover the deficit, the government borrows money.

A government is liable to provide public services to all members of the society. The main items of public services include defense, internal security, and social services including education and healthcare. In return, all members of the society, regardless of their wealth, are liable to cover the deficit in government's budget (Nothing for free).

The main causes of economic inequality include the natural differential in personal capacities and inflation. The different wealth-acquiring behaviors due to the natural differential in personal capacities have its justification because it brings up the different roles of individuals in building the society. Rich benefit from inequality. Without the contribution of others in building the country, wealthy people cannot be as rich as they are. Because of inflation rich become wealthier. Rich have the interest to maintain social stability and continuously acquire contributions of others in building the society.

Structuring of the redistribution system should be based on the recognition of the liability of all members of the society to recover the deficit in the government budget and the recognition

of the right of poor and those of limited income to be compensated by rich. A sound redistribution system aims to achieve four main goals:

1. To sustain individuals at or above a specified material standard of living.
2. To provide sufficient funds to cover the deficit in government's budget.
3. To get rid of all present taxes, retirement programs and social security systems.
4. To help governments improve quality of public services including educational and health care systems.

The proposed redistribution system works as follows:

- The government determines the individual's share in the deficit of government budget. The deficit is distributed evenly among all members of the society.
- The government estimates the individual's standard cost of living with consideration given to age, gender, number of dependents, and living standard in the community. The individual's standard cost of living includes the individual's share in the deficit of government budget. Standard cost of living is not a stable figure. It can be changed according to the changes in development needs, product mix and living standard in the community. It can be increased in emergency cases such as war and natural catastrophes.
- The family's standard cost of living is the total sum of the standard cost of living of the household and all dependents.
- A wealth duty is levied on those families of incomes exceed the standard cost of living in order to cover the deficit in the incomes of those families of incomes less than the standard cost of living. Unlike taxes, wealth duty is not public revenue and it is not imposed on productive entities.
- Every individual is charged by his share in the deficit of the government budget.
- The government has to apply strict controls to prevent the dependency for living on the benefits of the redistribution system.

## 5. Absence of an International Monetary System

Universal currency refers to the currency which is used for settlement of foreign obligations. Its main purpose is to protect rights of exporters and foreign creditors. The measures of accepting a universal currency differs from those of a national currency. Gold is the historically accepted backing for the currency that was used in international transactions.

During the age of the gold standard, the British pound sterling was the universal reserve currency. After World War II, the US dollar was given this status by international treaty according to which the Fed was committed to hold enough gold to honor all its outstanding currency in gold at \$35 per ounce. In 1971, the Fed abrogated its responsibilities to honor dollar for gold entirely.

Since the 2008 financial crisis, the Fed has been inflating the dollar massively, Public debt grows sharply, and the purchasing power of the dollar falls dramatically. In the absence of an international monetary system, rights of exporters and holders of foreign currencies become questionable. Some countries try to eliminate the risk through holding currency reserve in form of a basket of currencies. Other countries start to barter their products or accept domestic currencies in exchange for exports.

A sound international monetary system aims to protect the rights of exporters and foreign creditors. It must be based on facts. First; the price of gold is unstable. Second; the universal currency must be fully backed by gold so as to protect rights of exporters and foreign creditors.

USA was liable to convert the dollar into gold at *fixed price*. The international monetary system failed because it was based on a commitment that ignores the fact that gold is naturally a commodity with variable market price.

A new independent universal currency can be considered for international trade and foreign transactions if the price of each unit of the universal currency is set to be equal to a *fixed quantity* of gold.

The universal currency can be issued by an independent universal bank. The universal bank sells universal money to central banks in exchange for the appropriate quantity of gold. Assume that each unit of the universal currency is set to be equal to 1/1000 of ounce of gold;

a 1 million of the universal currency will be sold to central banks in exchange for 1000 ounce of gold. Delivery of the universal money can be made in form of banknotes or credited to the account of the central bank with the universal bank. It is the responsibility of the universal bank to honor universal money for the appropriate quantity of gold. For the universal bank, price of gold is irrelevant.

The universal currency derives its value from the market price of gold. International currency exchange markets determine the exchange rate of the universal currency in terms of the different domestic currencies. The higher price of gold is the lower exchange prices of all national currencies for the universal currency. Prices of exports and foreign obligations are set in term of units of the universal currency which is fully backed by gold. Since the exchange is actually made between two valued commodities, the rights of exporters and foreign creditors are protected.

## **6. Conclusion**

Wise management of resources in addition to transformation of present inflationary economies into pure productive economies is the key to structure a sound economic system.

Unlike present inflationary economic systems, the proposed economic system is fair, integrated, and self-correcting system. It is dynamic in such a way to comply with present complex requirements of societies and accelerated technological improvements.

The views expressed here are undoubtedly drastically different from the views of other researchers. However, financial distress is increasing and people will, sooner or later, realize the truth and make concert efforts to gradually embrace an alternative system that would reflect fair economy, and advance the needs of humanity as a whole.

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